REPORT OF THE AUDITOR-GENERAL TO THE EASTERN CAPE PROVINCIAL LEGISLATURE AND THE COUNCIL ON MAKANA MUNICIPALITY

REPORT ON THE FINANCIAL STATEMENTS

Introduction

1. I was engaged to audit the accompanying financial statements of the Makana Municipality which comprise the statement of financial position as at 30 June 2011, and the statement of financial performance, statement of changes in net assets and cash flow statement for the year then ended, a summary of significant accounting policies and other explanatory information, as set out on pages ... to ....

Accounting officer's responsibility for the financial statements

2. The accounting officer is responsible for the preparation and fair presentation of these financial statements in accordance with South African Standards of Generally Recognised Accounting Practice (GRAP) and in the manner required by the Municipal Finance Management Act, 2003 (Act No. 56 of 2003) (MFMA) and the Division of Revenue Act of South Africa, 2010 (Act No. 1 of 2010 as amended) (DoRA), and for such internal control as management determines necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor-general's responsibility

3. As required by section 188 of the Constitution of South Africa, 1996 (Act No. 108 of 1996) and section 4 of the Public Audit Act of South Africa, 2004 (Act No. 25 of 2004) (PAA) and section 126(3) of the MFMA, my responsibility is to express an opinion on the financial statements based on conducting the audit in accordance with the International Standards on Auditing and *General notice 1111 of 2010* issued in *Government Gazette 33872 of 15 December 2010*. Because of the matters described in the basis for disclaimer of opinion paragraphs, I was unable to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Basis for disclaimer of opinion

Investment property

4. South African Standards of Generally Recognised Accounting Practice, GRAP 16, *Investment property*, requires property held to earn rentals or for capital appreciation to be recognised as investment property. Land held for an undetermined use is also classified as investment property. The municipality did not identify and disclose separately the investment properties included in its asset register. I was unable to confirm or verify by alternative means the value of investment properties included in the carrying amount disclosed for property, plant and equipment. The fair value of the investment property has as a result also not been disclosed separately in the financial statements. Consequently, I did not obtain sufficient appropriate audit evidence to satisfy myself as to the valuation of investment properties and the amount by which property plant and equipment is overstated.

Creditors

5. Included in the amount of R64 million (2010: R31 million) for creditors are a number of suspense accounts amounting to R27 million. These suspense accounts were not reconciled at year-end and the municipality could not provide sufficient explanations or supporting documentation for the entries included in the accounts. I could not determine the effect on the other account balances or classes of transactions contained in the financial statements. Supporting documentation could not be provided for journal entries amounting to R9,5 million that was processed to accounts payable during the year. Consequently, I did not obtain sufficient appropriate audit evidence to satisfy myself as to the existence and valuation of creditors.

Bank overdraft

6. Supporting documentation could not be provided for journal entries amounting to R33 million that was processed to the bank account in the general ledger. The municipality could further not provide sufficient appropriate audit evidence to support reconciling items totalling R3,8 million between the bank overdraft stated in the statement of financial position at R3,5 million and the cash at banks amount stated on the year-end bank reconciliation at R4,1 million. There is a further difference of R3,2 million between the bank overdraft as disclosed in the statement of financial position and the cash book balance (overdraft) of R6,7 million per the bank reconciliation. Consequently, I did not obtain sufficient appropriate audit evidence to satisfy myself as to the existence, obligation, completeness and valuation and allocation of the bank overdraft.

Property, plant and equipment

7. Additions to property plant and equipment (PPE) amounted to R70 million. Supporting documentation for additions amounting to R15,8 million could not be provided for audit purposes. Consequently, I did not obtain sufficient appropriate audit evidence to satisfy myself as to the valuation and allocation of the additions.

8. Included in the carrying value of R1,4 billion (2010: R1,4 billion) for Property, plant and equipment are properties to the amount of R82 million that are not registered in the name of the municipality. The municipality's rights and ownership to these properties could not be confirmed.

9. The values assigned to the land and buildings as disclosed in the annual financial statements at the carrying value of R867 million do not agree to the values as per the valuation roll of the municipality. This resulted in an overstatement of land and buildings and the accumulated surplus to the amount of R23 million.

10. The Standards of Generally Recognised Accounting Practice, GRAP 17, *Property, plant and equipment* states that subsequent to initial recognition at cost, an item of property, plant and equipment should be carried at cost less accumulated depreciation and accumulated impairment losses or at a revalued amount less accumulated depreciation and accumulated impairment losses. Due to the first time implementation of GRAP 17, depreciation had to be calculated for the 2008 and 2009 financial years. The backlog depreciation for these financial years has been incorrectly calculated. The depreciation for the 2010 and 2011 financial years had also been calculated incorrectly.

11. Had depreciation been provided for, the surplus for the period would have been stated at R1,346 billion; property and plant and equipment would have been reduced by an accumulated depreciation of R63,6 million.

12. Furthermore, value-added tax (VAT) was not accounted for accurately on all additions to property, plant and equipment, resulting in an overstatement of the carrying value of property, plant and equipment and understatement of input tax claimed from SARS amounting to R3 million.

Accounts receivable

13. Included in the amount of R40 million (2010: R46 million) for Trade Receivables from Exchange Transactions is a suspense account balance of R9,6 million. This suspense account was not reconciled at year end and the municipality could not provide sufficient explanations or supporting documentation for the entries included in the account. I could not determine the effect on the other account balances or classes of transactions contained in the financial statements.

Leave accrual

14. There was no adequate system of control over leave management on which I could rely for the purpose of my audit as employees' leave was not captured timeously and attendance registers and leave forms were not adequately maintained. The municipality's accounting records did not permit the application of alternative audit procedures. Consequently I did not obtain sufficient appropriate audit evidence to satisfy myself as to the existence, obligations, completeness, and valuation and allocation of leave accrual amounting to R5 million (2010: R4 million) as disclosed in note 13 of the annual financial statements.

Accumulated Surplus

15. Included on the Statement of Changes in Net Assets (SCNA) is an amount of R23,7 million that per the SCNA relates to the effect of change in accounting policy on property, plant and equipment and unspent conditional grants. The municipality could not provide sufficient explanations or supporting documentation for this amount. I could not determine the effect on the other account balances or classes of transactions contained in the financial statements.

Corresponding figures

16. The auditor's report for the year ended 30 June 2010 contained a disclaimer of opinion on the financial statements as a whole due to a limitation on the scope of the audit. The matters which gave rise to the limitation, as described below, remain unresolved in the current year.

17. The municipality could not provide sufficient appropriate audit evidence regarding the following:

- Reconciling items to the amount of R9 million between the bank overdraft of R3,9 million and the cash book balance of R2,7 million as per the year end bank reconciliation.
- Existence of debtors amounting to R16 million.
- The write-off of trade payables amounting to R1,4 million and the existence and valuation of other payables amounting to R2,7 million;
- The existence, obligations, completeness and valuation and allocation of the leave pay accrual amounting to R4,1 million.
- The occurrence, completeness, accuracy, cut-off and classification of other revenue amounting to R4,4 million.

18. I was unable to confirm or verify these amounts by alternative means and as a result, could not confirm the existence, valuation, completeness or rights and obligations of the abovementioned amounts included in the corresponding figures.

Disclaimer of opinion

19. Because of the significance of the matters described in the basis for disclaimer of opinion paragraphs, I have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, I do not express an opinion on the financial statements.

Emphasis of matters

20. I draw attention to the matters below.

Significant uncertainties

21. As disclosed in note 45.1 to the financial statements, the municipality is the defendant in a number of lawsuits estimated to amount to R50 million. The municipality is opposing these claims. The ultimate outcome of these matters cannot presently be determined, and no provision for any liability that may result has been made in the financial statements.

Restatement of corresponding figures

22. As disclosed in note 35 to the financial statements, the corresponding figures in the financial statements for 30 June 2010 have been restated as a result of a change in accounting policy during the financial year ended 30 June 2011. The municipality previously opted to take advantage of the transitional provisions as set out in Directive 4.

23. At 30 June 2011, the municipality was no longer able to apply the above-mentioned transitional provisions, and thus the municipality had to retrospectively adjust the provisional amounts recognised in the prior year financial statements

24. The effect of the change in accounting policy is on the corresponding figures are as follows:

    - Increase in the accumulated surplus and assets – R1,081 billion
    - Increase in depreciation and amortization – R43 million

Unauthorised expenditure

25. Unauthorised expenditure with a value of R47,7 million was identified during the audit. This related to overspending on votes and was not identified by the municipality as being unauthorised or disclosed in the initial annual financial statements submitted for audit in note 39.1

Irregular expenditure

26. Irregular expenditure amounting to R3,7 million was identified and disclosed by management in the initial annual financial statements submitted for audit. Additional irregular expenditure amounting to R7 million was identified during the audit and included in the amount of R10,8 million as disclosed in note 39.3 to the corrected financial statements. The irregular expenditure relates mainly to instances of non-compliance with the Supply Chain Regulations and Public Office Bearers Act, 1998 (Act No. 20 of 1998).

Fruitless and wasteful expenditure

27. As disclosed in note 39.2 to the financial statements fruitless and wasteful expenditure amounting to R2,4 million was incurred during the financial year ended 30 June 2011. Of this amount R743 928 was identified by management and disclosed in the initial annual financial statements submitted for audit and R1,6 million was identified during the audit and is included in the amount disclosed in the corrected financial statements.

Material losses and impairment

28. As disclosed in notes 3 and 4 to the annual financial statements material losses were incurred during the year relating to the impairment of their receivables balances. The loss recognised in the statement of financial performance of the current financial year amounted to R41 million while R10 million of the opening provision was written off as irrecoverable.

29. The municipality incurred material losses in respect of water and electricity during the year as disclosed in note 40.9 to the annual financial statements.

Material under-spending of the capital budget

30. As disclosed in note 7 to the financial statements, the municipality incurred R70 million (72% of capital expenditure budget) in respect of capital expenditure. This represents a material under-spending of R27 million (28%) in respect of the capital expenditure budget, mainly related to electricity, water and municipal infrastructure grant projects. The under-spending had a negative impact on the municipality achieving its service delivery mandate.

Additional matters

31. I draw attention to the matter below.

Unaudited supplementary schedules

32. The supplementary information set out on pages ... to ... does not form part of the financial statements and is presented as additional information. I have not audited these schedules and accordingly I do not express an opinion thereon.

REPORT ON OTHER LEGAL AND REGULATORY REQUIREMENTS

33. In accordance with the PAA and in terms of *General notice 1111 of 2010*, issued in *Government Gazette 33872 of 15 December 2010,* I include below my findings on the annual performance report as set out on pages ... to ... and material non-compliance with laws and regulations applicable to the Makana Municipality.

Predetermined objectives

Presentation of information

34. The following criterion is relevant to the findings below:

    - Performance against predetermined objectives is reported in accordance with section 46 of the Municipal Systems Act of South Africa, 2000 (Act No. 32 of 2000) (MSA).

Audit findings

35. **Measures taken to improve performance were not provided in the annual performance report (APR)**

    Measures taken to improve performance were not provided in the APR, as required in terms of section 46(1)(c) of the MSA. In total 67% of the reported targets had no details of the measures taken to improve performance

Usefulness of information

36. The following criteria are relevant to the findings below:

    - Consistency: Objectives, indicators and targets are consistent between planning and reporting documents.
    - Measurability: Indicators are well defined and/or verifiable, and targets are specific, and/or measurable and/or time bound.

Audit findings

37. **Reported indicators included in the integrated development plan (IDP) and the APR are not consistent (consistency)**

    In total 22% of the number of indicators included in the APR are not consistent with the planned indicators as contained in the IDP.

38. **No targets reflected in the (APR)**

    The APR did not reflect the targets set for the reported indicators.

39. **Planned and reported indicators and targets are not well defined, specific or time bound (measurability)**

    - In total 51% of the indicators reviewed were considered not to be well-defined in that they do not have a clear unambiguous definitions, are not defined in such a manner that data will be collected consistently and be easy to understand and use
    - In total 74% of the targets reviewed were considered not to be specific since the nature and required level of performance are not clearly identifiable.
    - One hundred per cent of the targets were found not to be time bound since the time period or deadline for delivery are not specified.

Compliance with laws and regulations

Expenditure management

40. Money owing by the municipality was not always paid within 30 days of receiving an invoice or statement, as required by section 65(2)(e) of the MFMA.

41. The accounting officer did not take all reasonable steps to ensure that the municipality had and maintained an effective system of expenditure control, including procedures for the approval, authorisation, withdrawal and payment of funds, as required by section 65(2)(a) of the MFMA.

42. The accounting officer did not take all reasonable steps to ensure that the municipality had and maintained a management, accounting and information system which recognised expenditure when it was incurred as required by section 65(2)(b) of the MFMA.

43. The accounting officer did not take reasonable steps to prevent unauthorised, irregular expenditure as well as fruitless and wasteful expenditure, as required by section 62(1)(d) of the MFMA.

Revenue management

44. The accounting officer did not take all reasonable steps to ensure that the municipality had and maintained a management, accounting and information system which recognised revenue when it is earned, accounted for debtors and accounted for receipts of revenue, as required by section 64(2)(e) of the MFMA.

Asset management

45. The accounting officer did not take all reasonable steps to ensure that the municipality had and maintained a management, accounting and information system which accounts for the assets of the municipality as required by section 63(2)(a) of the MFMA.

46. The accounting officer did not take all reasonable steps to ensure that the municipality had and maintained an effective system of internal control for assets (including an asset register) as required by section 63(2)(c) of the MFMA.

Budgets

47. The municipality incurred expenditure in excess of the limits of the amounts provided for in the votes in the approved budget, in contravention of section 15 of the MFMA. This resulted in unauthorised expenditure to the value of R47,7 million as reported in paragraph 28 above.

48. The mayor did not submit all quarterly reports to the council on the implementation of the budget and the financial state of affairs of the municipality within 30 days after the end of each quarter, as required by section 52(d) of the MFMA.

49. The annual budget of the municipality is not based on the development priorities and objectives as well as the performance targets set by the municipality in its IDP as required by regulation 6 of the Municipal Planning and Performance Management Regulations, 2001.

Annual financial statements and APR

50. The annual financial statements submitted for auditing were not prepared in all material respects in accordance with the requirements of section 122 of the MFMA. Material misstatements of property, plant and equipment, current assets and liabilities, revenue, expenditure and disclosure items identified by the auditors were subsequently corrected. Material limitations in scope relating to the numerous material journal entries, bank overdraft and numerous suspense accounts resulted in the financial statements receiving a disclaimed audit opinion.

51. The accounting officer did not submit the annual financial statements of the municipality for auditing, within two months after the end of the financial year as required by section 126(1)(a) of the MFMA.

52. The municipal council did not adopt an oversight report containing the council's comments on the annual report within two months from the date on which the 2009/10 annual report was tabled in the council as required by section 129(1) of the MFMA.

53. The performance report for the financial year under review was not prepared as required by section 46 of the MSA read with section 121(3)(c) of the MFMA.

54. The APR did not contain a comparison of the current year performance of the municipality with that of the prior year, the performance of each external service provider and measures to improve performance were not reflected in the annual performance report in all instances as required by section 46 of the MSA.

Internal audit

55. The internal auditors of the municipality did not audit the performance measures on a continuous basis and did not submit quarterly reports on their audits to the municipal manager and the audit committee as required by Municipal Planning and Performance Management Regulation 14.

Procurement and contract management

56. In terms of section 62(1)(b) of the MFMA the accounting officer is responsible for managing the financial administration of the municipality, and must for this purpose take all reasonable steps to ensure that full and proper records of the financial affairs of the municipality are kept in accordance with any norms and standards.

57. The following instances of non-compliance with the supply chain management (SCM) regulations were identified notwithstanding the fact that all the required SCM could not be provided for audit purposes.

58. Awards were made to providers who are persons in service of other state institutions or whose directors/principal shareholders are persons in service of other state institutions in contravention of the requirements of SCM regulation 44.

59. Goods and services with a transaction value of between R10 000 and R200 000 were procured without obtaining written price quotations from at least three different prospective providers as per the requirements of SCM regulations 17(a) and (c).

60. Quotations were accepted from prospective providers who are not on the list of accredited prospective providers and do not meet the listing requirements prescribed by the SCM policy in contravention of SCM regulations 16(b) and 17(b).

61. Goods and services of a transaction value above R200 000 were procured without inviting competitive bids as per the requirements of SCM regulations 19(a) and 36(1).

62. Awards were made to providers based on criteria that were not stipulated in the original bid documents as per the requirements of SCM regulation 28(1).

63. Invitations for competitive bidding were not always advertised for a required minimum period of days as per the requirements of SCM regulations 22(1) and 22(2).

64. Bid specifications were not always drafted by bid specification committees which were composed of one or more officials of the municipality as required by SCM regulation 27(3).

65. Sufficient appropriate audit evidence could not be obtained that bids were evaluated by bid evaluation committees which were composed of officials from the departments requiring the goods or services and at least one SCM practitioner of the municipality as per the requirements of SCM regulation 28(2).

66. Final awards and/or recommendation of awards to the accounting officer were not always made by an adjudication committee which was constituted of the chief financial officer (CFO) or another senior manager as designated by the CFO as per the requirements SCM regulation 29(2).

67. Awards were made to providers whose tax matters had not been declared by the South African Revenue Service (SARS) to be in order as required by SCM regulation 43.

68. Awards were made to suppliers who did not submit a declaration on their employment by the state or their relationship to a person employed by the state as per the requirements of municipal SCM regulation 13(c).

69. The preference point system was not applied in all procurement of goods and services above R30 000 as required by section 2(a) of the Preferential Procurement Policy Framework Act and SCM regulation 28(1)(a).

70. Awards were made to suppliers based on preference points that were not allocated in accordance with the requirements of the Preferential Procurement Policy Framework Act and its regulations.

71. Awards were made to suppliers who did not score the highest points in the evaluation process as per the requirements of section 2(1)(f) of Preferential Procurement Policy Framework Act.

72. The performance of contractors or providers was not monitored on a monthly basis, as required by section 116(2)(b) of the MFMA.

73. The contract performance measures and methods whereby they are monitored were insufficient to ensure effective contract management as per the requirements of section 116(2)(c) of the MFMA.

74. Awards were made to bidders other than those recommended by the bid evaluation committee without ratification by the accounting officer, as required by SCM regulation 29(5)(b).

INTERNAL CONTROL

75. In accordance with the PAA and in terms of *General notice 1111 of 2010*, issued in *Government Gazette 33872 of 15 December 2010,* I considered internal control relevant to my audit, but not for the purpose of expressing an opinion on the effectiveness of internal control. The matters reported below are limited to the significant deficiencies that resulted in the basis for disclaimer of opinion, the findings on the annual performance report and the findings on compliance with laws and regulations included in this report.

Leadership

76. Effective leadership based on ethical business practices and good governance, protecting and enhancing the best interest of the municipality was not demonstrated by top management. During the year under review the CFO was suspended and investigated for possible irregularities pertaining to SCM. An investigation was also in progress at year end into the alleged circumvention of the SCM policies by the former executive mayor in appointment of a service provider to provide a development academy for sport training and coaching sessions.

77. Quality is not understood by all to be a prerequisite because there are a number of significant findings on internal controls, financial management and reporting on predetermined objectives. Furthermore the misstatements of the prior financial year have not been addressed and are repeated in the current year. This was also the case in the 2010 financial year with the result that the misstatements of at least the prior two financial years have not been addressed.

78. Management was not able to implement effective human resource management to ensure that adequate and sufficient skilled resources are in place and that performance is monitored. This contributed to the significant number of material misstatements identified in the financial statements, findings on the predetermined objectives and non compliance with laws.

79. The accounting officer did not exercise adequate oversight responsibility over reporting and compliance with laws and regulations and internal control because there are a number of findings relating to internal control environment and compliance with laws and regulations in general but specifically related to procurement (SCM). As a result unauthorised, irregular as well as fruitless and wasteful expenditure was incurred as disclosed in the annual financial statements.

80. Although management did develop an action plan to address the external audit findings of the prior years, the implementation of the plan was not adequately monitored resulting in similar findings occurring in the current financial year.

81. The municipality does not have a formal information technology (IT) governance framework in place which provides comprehensive guidelines for IT decision making. In addition, there is no formal project management framework, no strategic plan or steering committee in place.

82. These deficiencies are attributed to the fact that there was no IT department at the municipality up to the beginning of October 2011. In addition IT governance was not a priority for the municipality.

Financial and performance management

83. The municipality does not have proper record keeping and record management systems in place, resulting in documents supporting the transactions and balances in the financial statements not being properly filed and easily retrievable. This contributed to material scope limitation relating to material journal entries processed in respect of bank and cash and a number of material suspense accounts not reconciled at year-end.

84. Quality and reliable financial statements and performance reports have not been prepared because the entity did not have staff knowledgeable about GRAP reporting framework and performance management requirements. This was evidenced by the fact that many material adjustments were required to be made to the annual financial statements. Consequently the financial statements initially submitted on 30 September 2011 were not in compliance with section 122(1)(a) of the MFMA since the financial statements did not fairly present the state of affairs of the municipality, the financial results and the financial position at the end of the financial year.

85. The implementation of controls over daily and monthly processing and reconciliations of transactions are not effective and resulted in inaccurate financial reporting. Suspense accounts are not reconciled, suppliers are not reconciled to statements, fixed asset registers are not reconciled to the ledger and VAT reconciliations are not adequately performed.

86. The review and monitoring of compliance with laws and regulations is not effective as there were numerous instances of non-compliance identified relating to:

a) expenditure management
b) revenue management
c) asset management
d) budget
e) annual financial statements and annual performance report
f) procurement and contract management.

87. The IT control environment is generally weak and this is mainly due to the fact that the municipality did not have an in-house IT resource to develop and implement formal controls over IT systems.

Governance

88. Appropriate risk management activities relating to financial reporting, performance reporting and compliance with laws and regulations have not been implemented during the financial year. There is also no IT risk and control framework in place, and no IT risk register.

89. Cognisance is taken of the work done by the internal audit, but the effectiveness of the internal audit is hampered by the limited budget allocated to this important function and therefore directly impacts on the effectiveness of the audit committee. As a result the internal audit did not function as envisaged by section 165(2) of the MFMA. The internal audit only reviewed and reported on the performance reports relating to the first two quarters of the performance year. The annual performance report submitted for audit was not reviewed by internal audit and reported on to the audit committee.

90. The municipality does have an audit committee in place, but it did not effectively discharge its duties as envisaged by section 166 of the MFMA. Although the committee reviewed the annual financial statements, the review is not considered effective due to the limited time afforded to the audit committee to review the statements and the lack of expertise to adequately review and interrogate the financial statements.

91. The number of findings related to misstatements in the financial statements, performance reporting and non-compliance with laws and regulations indicates that more oversight is required.

Investigations

92. An investigation into alleged irregularities committed by the CFO was conducted by an independent consulting firm on request of the accounting officer. The investigation was initiated based on the allegation of possible irregularities in the appointment and continued use of consultants at the finance directorate. The investigation was still in progress at 30 June 2011.

93. An investigation into alleged deviation from the SCM policy for payment made to a supplier relating to sport training and coaching sessions. The investigation was completed during the year and it was recommended that no further payments be made to the suppliers, that the expenditure be deemed as irregular and that steps be taken to recover the irregular expenditure already incurred.

94. An investigation into alleged irregularities related to the awarding of two infrastructure contracts was conducted by an independent consulting firm on request of the accounting officer. The investigation was initiated based on the allegation of possible collusion between the contactors and municipal officials. The investigation was completed during the year and it was recommended that a criminal case be reported to the South African Police Service.

Auditor General.

Port Elizabeth

31 December 2011

AUDITOR-GENERAL
SOUTH AFRICA

Auditing to build public confidence